



North Carolina Department of Revenue

Roy Cooper
Governor

March 1, 2017

Ronald G. Penny
Acting Secretary

MEMORANDUM

TO: The Honorable Phil Berger Senator Andrew Brock
 President Pro Tempore Senator Jerry Tillman
 Senator Tommy Tucker

 The Honorable Tim Moore Representative Bill Brawley, Senior Chair
 Speaker of the House Representative Jason Saine, Senior Chair
 Representative Kelly Hastings
 Representative Susan Martin
 Representative Mitchell Setzer
 Representative John Szoka

FROM: Ronald G. Penny
 Acting Secretary, North Carolina Department of Revenue

 John Correllus
 Director, Government Data Analytics Center

SUBJECT: Semi-Annual Report:
 Progress Report NCDOR – GDAC July 1, 2016– January 31, 2017

This semi-annual report is prepared pursuant to Session Law 2015-259, Section 7.3(b) (House Bill 117). This report reflects a collaborative effort by the North Carolina Department of Revenue (NCDOR) and the Government Data Analytics Center (GDAC). NCDOR and GDAC are required to provide progress reports to the Revenue Laws Study Committee on:

- 1) Prevention or reduction of the occurrence of stolen identities and refund fraud.
- 2) Elimination of fraudulent returns.
- 3) Tax compliance by business professionals and alcohol vendors.
- 4) Coordination of efforts between the Department of Revenue and the Government Data Analytics Center to identify and integrate into the Department's operations and procedures the most effective and accurate processes and scalable tools available to reduce refund fraud, payment of fraudulent returns, and business tax compliance.

The NCDOR's mission is to administer the tax laws and collect the taxes due the State in an impartial, uniform, and efficient manner. To support this mission, the Examination

Division's primary objective is to identify noncompliance with state tax laws, audit the books and records of individuals and businesses not in compliance, and assess and collect unpaid revenue owed to the State. The Examination Division implements various operational strategies to realize the lowest possible operating cost per dollar of revenue assessed. All operational decisions and audit initiatives adhere to five pillars that serve as the foundation for the Division's strategic plan. These pillars are:

- Audit Selection
- Quality Audits
- Accountability
- Resource Alignment
- Employee Development

Through the partnership with GDAC, the NCDOR has identified short term and long term projects to:

1. Enhance efficiency through automation;
2. Streamline and improve audit candidate research and selection;
3. Utilize specific data sources, selection criteria, and data analytics to identify non-compliance within specific industries;
4. Compile multiple data sources to identify new areas of non-compliance

This report is broken into four components to correspond with the reporting requirements from of S.L. 2015-259, Sec. 7.3(b).

NCDOR's overall strategy for identity theft refund fraud and non-identity theft refund includes an increase in voluntary compliance and reduction occurrences. Therefore, response to (1) is included in item (2).

- 1) Prevention or Reduction of the Occurrence of Stolen Identities and Refund Fraud**
- 2) Enhancements to Identification of Fraudulent Returns and Refund Fraud**

The NCDOR, in partnership with SAS and GDAC, utilizes multiple internal and external data sources, data analytics, reported occurrences of stolen information, and a specialized team of auditors as a base for our refund fraud program. Our refund fraud program must be technologically current and agile to maintain a status of being able to keep up with current fraudulent schemes.

The agency has realized a substantial increase of reported occurrences of compromised personal identifying information from individuals and companies this year. The Examination Division and The Office of Taxpayer Advocate continue to enhance our process for receiving claims of compromised personal information and integrating this data into our Identity Theft Refund Fraud Program. Our enhanced process to detect identity theft refund fraud, combined with our streamlined process to collect information from individuals and companies reporting compromised information, will aid in our detection of tax returns filed using stolen personal identifying information prior to issuance of a refund.

Provisions of G.S. 105-259 preclude the NCDOR from providing detail regarding the specific data and standards used within the process to determine identity theft refund fraud and non-identity theft refund fraud; however, the Examination Division, with SAS

and GDAC, have implemented additional enhancements to our refund fraud program since our last status report dated September 1, 2016. As a result of the increase in refund fraud cases each year and limited resources, enhancements to our refund fraud program include, but are not limited to, improvements in case prioritization.

It is our expectation, the high adoption rate from taxpayers reporting real time NC-3 information electronically, integrated with enhanced data analytics, will substantially improve our ability to capture identity theft refund fraud and ensure (1), refund tax savings are optimized and (2), taxpayer victims of identity theft will realize an efficient method of meeting their tax filing obligation. We are also able to detect inflated withholding, real time, as a result of electronic NC-3 reporting, which will minimize the issuance of erroneous refunds. The peak for refund fraud and identity theft refund fraud generally starts in February and ends in April; however, we receive, review, and work fraudulent cases throughout the year. Refund fraud statistics for this filing season will be at the close of the fiscal year, June 30, 2017. For period July 1, 2016 through January 31, 2017 we have realized \$3.3 million in tax savings and assessments attributable to our relationship with GDAC/SAS. For an annual perspective, fiscal year ending June 30, 2016, we realized over \$32 million in tax savings from refund fraud and identity theft refund fraud.

The Discovery Section of the NCDOR's Examination Division is comprised of 11 staff members. The Examination Division routinely re-allocates staff to different initiatives and programs to ensure efficiency and maximize the Agency's return on investment. The Examination Division will re-allocate 6 additional staff members to the refund fraud process to maintain a proper balance of ensuring tax refunds are issued timely and refund fraud is identified effectively. Any impacts to other compliance initiatives will be stabilized and overcome within a timely manner.

3) Tax Compliance by Business Professionals and Alcohol Vendors

The Examination Division worked directly with ABC Boards, Beer and Wine Wholesalers, Independent Brewers, Occupational Licensing Boards, and their vendors to implement a streamlined process for submitting required information to the NCDOR. Although the information was not required to be submitted to the NCDOR in an electronic form, Exam division staff worked with the taxpayers, NCDOR-IT, GDAC, and SAS, to ensure the data was predominantly submitted in a format that could be processed electronically.

Specific formatting criteria was published and communicated to taxpayers to ensure the NCDOR received the information in a consistent format that could readily be utilized for compliance initiatives. Information this year required extensive cleansing to make the data available for analytics when aggregated with other data sources. A strategy has been developed for SAS to host the platform in 2018 for data collection to ensure a streamlined reporting process and efficient flow for identification of non-compliance and subsequent audit initiatives.

Because of the data submitted already by the listed taxpayers pursuant to G.S. 105-251.2, the Examination Division has developed an audit initiative designed to identify non-compliance within the cash intensive businesses. This initiative requires extensive training to educate a designated group of NCDOR auditors on a new, indirect audit method made possible by the investment in GDAC analytics. This method, in conjunction with the information reporting received by the taxpayer will streamline the

audit process, reduce unproductive direct audit hours, ensure accurate audit results, and solidify case attributes should litigation of the case ensue. Additional information reporting will increase auditor efficiency within identification of non-compliance and the audit process.

The NCDOR will recommend to the Revenue Laws Study Committee to consider requiring all IRS 1099K information be reported to the NCDOR. Currently, taxpayers (predominantly credit card vendors) are required to report 1099K information to the IRS only and North Carolina does not receive the data set until a minimum of two years later. The delayed data reduces its useful life with regards to effective audit opportunities and for collection actions. NCDOR conducted a Pilot initiative utilizing SAS's Business Entity Recognition platform, which enabled the Agency to streamline their identification of potential non-compliance from 1099K data. NCDOR has completed 20 cases as of December 2016 totaling \$1.2 million in assessments. 1099K reporting requirement directly to the NCDOR will automate this initiative and improve non-compliance within cash intensive businesses. One case is under criminal investigation and many other cases are in progress at this time; however, all cases have clearly identified gross underreporting of cash transactions. Adding the 1099K annual filing requirement would provide North Carolina an opportunity to remain at the cutting edge of tax compliance.

4) Coordination of Efforts Between the NCDOR and GDAC to Identify and Integrate into the Department's Operations and Procedures, the Most Effective and Accurate Processes and Scalable Tools Available to Reduce Refund Fraud, Payment of Fraudulent Returns, and Business Tax Compliance

The NCDOR's partnership with GDAC has resulted in short and long-range deployment of specific programs designed to either streamline audit process and realize efficiency gains, improve audit selection and resource allocation by specific data analytical tools, and identify new areas of non-compliance by utilizing multiple data sources and analytics. G.S. 105-259 precludes the NCDOR from providing specific details regarding data and standards used to determine selection of audit candidates. However, as a result of the automation of one component of the NCDOR's audit process, the Department has realized an efficiency gain of \$5.3 million on an annual basis. Our continued partnership with GDAC and SAS enables us to continue to roll out the multiple phases of our Advanced Data Analytics model designed to reduce administrative research hours, prioritize audit selection, and more efficiently allocate direct auditor hours. NCDOR has identified multiple audit program enhancements and many other new audit initiatives planned as a partnership with GDAC/SAS for future implementation designed to effectively recover lost revenue.

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